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No. 349

In the Supreme Court of the United States

OCTOBER TERM, 1931

OLD COLONY RAILROAD COMPANY, PETITIONER

v.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The findings of fact and opinion of the Board of Tax Appeals (R. 40–60) are reported in 18 B. T. A. 267. The opinion of the Circuit Court of Appeals, reversing the decision of the Board (R. 73–75), is reported in 50 F. (2d) 896.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered June 10, 1931. (R. 75.) Petition for certiorari was filed September 3, 1931, and granted October 26, 1931. (R. 77.) The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, under the accrual system of accounting, the amount of the premium received on the sale of long-term corporate bonds, issued by the petitioner prior to 1904 and outstanding during 1921, may be amortized over the life of the bonds, and the amortized portion of such premium applicable to 1921 be included in the petitioner's gross income in that year for the purpose of reducing the amount of the "interest paid" deduction, claimed by the petitioner under Section 234 (a) (2) of the Revenue Act of 1921, to the extent that the asserted amount of "interest paid" represents a repayment in part of the premium.

STATUTES, REGULATIONS, ETC., INVOLVED

The applicable provisions of the Revenue Act of 1921 and the Treasury Regulations, excerpts from the Interstate Commerce Commission's classifications of accounts and form of General Balance Sheet Statement for Steam Roads, and excerpts from various accounting texts, are set forth in the Appendix, pp. 40–52, *infra*.

STATEMENT

The petitioner is, and was during 1921, a Massachusetts corporation. (R. 42.) It kept its accounts upon the accrual basis. (R. 49.)

By a lease dated February 15, 1893, which was in force during 1921, the petitioner leased its railroad lines and all other property to the New York,

New Haven & Hartford Railroad Company, hereinafter referred to as the "New Haven," for a term of 99 years. (R. 42.) Under the lease the New Haven agreed to operate and maintain the petitioner's railroad during the term of the lease, to assume the payment of the principal of and interest upon the petitioner's bonded indebtedness and other obligations, and to pay annually, as rental, a sum equal to a specified rate of dividends upon the capital stock of the petitioner.[1]

During the years 1895 to 1904, inclusive, and while the above-described lease was in force, the petitioner issued and sold certain long-term bonds, and received therefor, in excess of the par value thereof, premiums aggregating $199,528.08. These bonds were outstanding during 1921. (R. 44.)

The record does not indicate what use was made by the petitioner of these premiums or how they were treated by the petitioner in its accounts, save that they were credited on the petitioner's books to an account designated as "Premium on Bond." (R. 44–45.) The credits thus entered remained undisturbed until 1914, when the petitioner was required by the Interstate Commerce Commission "to amortize such premiums over the periods of the respective lives of the bonds." (R. 45.) The peti-

[1] A copy of the lease was attached to the petitioner's petition to the Board of Tax Appeals, as Exhibit B. (R. 16–22.) The findings of the Board incorporated the terms of the lease by reference. (R. 42, 73.)

tioner complied with this requirement under protest. The ratable proportion of the premiums applicable to the years prior to 1914 was extinguished by appropriate entries, and, for 1914 and thereafter, the petitioner reported to the Interstate Commerce Commission as income a yearly ratable proportion of the remainder of these premiums. This yearly sum was entered on its books as a credit to profit and loss (a surplus account) and not to its income account. The proportion of the premiums attributable to the year 1921 and reported to the Interstate Commerce Commission as income for that year was $6,960.64. (R. 45.)

During 1921 the New Haven paid to the bondholders of the petitioner the sum of $538,920 as interest on the bonds in question. (R. 64.) The bonds were the direct obligation of the petitioner to the owners of the bonds and no agreement has ever been executed between the petitioner and the bondholders releasing the petitioner from such direct liability.[2] (R. 64–65, 66–67.)

In its income-tax return for the year 1921 the petitioner included the sum of $538,920 as an item of gross income and took a deduction from gross income of a like amount as interest paid during the year. (R. 65.) It thus did not include in its return for 1921 as taxable income the sum of $6,960.64 above described.

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[2] The amended findings of the Board set forth the provisions of the bonds as to the payment of principal and interest. (R. 65–66.)

The Commissioner, in auditing the petitioner's return for 1921 made no adjustment with respect to either the inclusion of $538,920 in gross income or the deduction of $538,920 therefrom, except to increase taxable income for the year by adding to the petitioner's gross income the sum of $6,960.64. (R. 45, 65.) Upon petition for redetermination of the deficiency found by the Commissioner, the Board, upon the authority of its prior decision in *Old Colony Railroad Co.* v. *Commissioner,* 6 B. T. A. 1025, affirmed, 26 F. (2d) 408 (C. C. A. 1st), held that the Commissioner erred in treating the $6,960.64 item of amortized premium as taxable income for 1921. (R. 50.) The Commissioner filed a motion for reconsideration on the ground that the Board had not considered the question presented by the record whether the amortized portion of the premiums applicable to 1921 should be considered in determining the amount of the interest deduction of the petitioner for that year. (R. 62–63.) This motion was denied. (R. 67.) Upon petition for review the Circuit Court of Appeals reversed the decision of the Board.[3] (R. 76.)

[3] In a previous case involving the petitioner's tax liability for the year 1920, the same Circuit Court of Appeals held that an amortized amount of the premiums received by the petitioner upon the sale of its bonds prior to March 1, 1913, should not be included in its taxable income for the year 1920. (26 F. (2d) 408.) The Commissioner of Internal Revenue filed a petition for certiorari, which was granted. (278 U. S. 592.) In this petition and in the Government's brief on the merits it was pointed out that while

SUMMARY OF ARGUMENT

Section 234 (a) (2) of the Revenue Act of 1921, which permits a taxpayer to deduct from gross income "All interest paid or accrued within the taxable year on its indebtedness," does not permit the deduction of that portion of a so-called "interest" payment which represents a pro-tanto repayment of a premium received upon the issuance and sale of bonds of the taxpayer.

A premium received on the sale of a bond is not in reality income, since it must be repaid, dollar for dollar, on a compound-interest basis, in amortized installments over the life of the bonds and in the form of *excess interest* carried by the bonds. That part of the annual "interest" payment which represents the repayment in part of the money received as a premium is not "interest" within the meaning of the statute, and is not deductible from gross income. The bookkeeping formula, under the accrual system of accounting, for preventing such deduction is to add to gross income for each year a sum equal to that part of the annual "interest" payment for that year which represents a

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in form the Commissioner treated the amortized portion of the premiums as income for 1920, in substance he reduced the amount of the deduction for interest claimed by the petitioner to the extent of such amortized portion of the premiums. But the case had not been tried upon that theory in the courts below, and upon an examination of the record it was found that it failed to disclose the amount of the interest deduction which had been claimed by the petitioner. The Commissioner thereupon filed a motion to dismiss the case, which was granted. (279 U. S. 876.)

repayment in part of the premium. This adjustment brings the interest on the bonds, which is properly deductible from gross income, to the *effective rate*, or that rate at which the bonds could have been sold at par; and the principle is equally applicable whether the bonds have been sold at a premium or at a discount.

The above principles were applied in the case at bar. The amortized portion of the premiums applicable to the year 1921 was treated as an item in the petitioner's gross income for that year for the purpose of offsetting and equalizing that part of the asserted "interest" on the bonds which represented a repayment in part of premiums, and which was not properly deductible as the cost attributable to the earning of that income.

The Revenue Act of 1921 permitted the petitioner to account in 1921 for an amortized portion of the premiums received on the sale of its bonds prior to 1904. It kept its books on the accrual basis and did so account for such portion. The Commissioner was required by the Act to compute the petitioner's net income in accordance with its own method of accounting, if that method reflected its true income. The petitioner's books, kept on an accrual basis, accurately reflected its true income for 1921, and the Commissioner properly computed the tax on that basis.

The petitioner's true net income should be determined for the taxable year 1921 by limiting the

deductions for that year to such costs and expenses, including interest paid, as are properly attributable to the earning of such income. This is, in effect, what the Commissioner did, and the validity of his act is to be judged, not by its form, but by what it accomplished.

The decision in the instant case is not contrary to the decisions of this Court which hold that Congress, under the Sixteenth Amendment to the Constitution of the United States, can not tax as income a gain which accrued prior to the effective date of the Amendment. To so hold would subvert the substance of the transactions here involved to mere matters of form.

The correctness of the action of the Commissioner and the decision of the court below are not affected by the fact that petitioner's lessee has assumed the payment of the principal of and interest on the bonds in question.

ARGUMENT

I

SECTION 234(a)(2) OF THE REVENUE ACT OF 1921 DID NOT PERMIT THE PETITIONER TO DEDUCT FROM ITS GROSS INCOME, AS INTEREST PAID ON ITS INDEBTEDNESS, THAT PORTION OF A SO-CALLED ANNUAL "INTEREST" PAYMENT ON CERTAIN LONG-TERM BONDS WHICH REPRESENTED A PRO-TANTO REPAYMENT OF A PREMIUM RECEIVED BY THE PETITIONER UPON THE ISSUANCE OF THE BONDS

The Government contends that the petitioner, in computing its net income for 1921, was not entitled to deduct from gross income the entire amount,

$538,920, paid in that year as "interest" on its bonds, but *only that amount less $6,960.64,* the latter amount being the amortized portion applicable to 1921 of the premium received by the petitioner upon the sale of the bonds. The Government contends that to the extent of $6,960.64 the payment of $538,920 was not a payment of "interest" but a pro tanto return of the premium, i. e., a repayment of part of the capital fund received upon the sale of the bonds, and as such, we submit, it was not deductible from gross income as "interest."

Section 234 (a) (2) of the Revenue Act of 1921, p. 41, *infra,* permitted the petitioner to deduct from gross income "All interest paid or accrued within the taxable year on its indebtedness." This Court has refused to give the word "interest," as used in tax and other statutes, a peremptory definition. *United States* v. *Childs,* 266 U. S. 304, 307. The Treasury Department, the Board of Tax Appeals, and the courts have consistently ruled that something which is called interest but which is in reality something else does not fall within the interest deduction permitted by the various revenue acts. Thus, Article 564 of Regulations 45 (1920 Ed.), issued under the Revenue Act of 1918, provided that—

> So-called interest on preferred stock, which is in reality a dividend thereon, can not be deducted in arriving at net income.

This provision was carried into Article 564 of Regulations 62, issued under the Revenue Act of

1921, the statute applicable to the instant case, and it has been continued in the subsequent regulations.[4] See also *Kentucky River Coal Corp.* v. *Lucas*, 51 F. (2d) 586 (W. D. Ky.); *Cloquet Co-operative Society* v. *Commissioner*, 21 B. T. A. 744; *McCoy-Garten Realty Co.* v. *Commissioner*, 14 B. T. A. 853; *West Music Co.* v. *Commissioner*, 14 B. T. A. 158; *Appeal of Kentucky River Coal Corporation*, 3 B. T. A. 644.

Since, obviously, the right to the interest deduction provided by the statute is not determined merely by the fact that a payment is designated by the taxpayer as "interest," an inquiry as to the true character of the payment in the instant case is required, and it is pertinent to consider the nature of bond premiums, the conditions under which they are paid, and their relation to and effect upon the computation of net income.

When the bonds in question were issued there was a rate of interest at which they could have been sold on the market at par. This rate is known as the *effective rate*. Because the petitioner was willing to pay a higher or *excess rate* of interest, it was able to sell the bonds at a premium. This premium was not, in essence, income but a lump payment made in return for the obligation, which the petitioner assumed, to pay such higher or excess rate

[4] See Article 564 of Regulations 65, issued under the Revenue Act of 1924; Article 564 of Regulations 69, issued under the Revenue Act of 1926; and Article 141 of Regulations 74, issued under the Revenue Act of 1928.

of interest during the life of the bonds. The premium represented the present value, as of the date of sale of the bonds, of the annual payments of excess interest which the petitioner agreed to make during the life of the bonds. The premium is thus repaid dollar for dollar in annual installments, which, for convenience, may be called excess interest.

The propositions set forth in the preceding paragraph are amply sustained by modern accounting authorities. Thus, in Kester, "Accounting, Theory, and Practice," it is said (pp. 367–368):

> At practically any time in the market there is a rate at which the bonds could be sold at par. This rate is known as the effective rate. If a company puts an issue of bonds on the market at a higher rate than this, the market will offer a premium for them. The amount of the premium will be, theoretically, the present value of the periodic sum represented by the difference between the stated bond interest and the effective interest, these periodic payments extending over the life of the bond. In other words, *the premium represents the price paid to buy the additional interest, dollar for dollar, on a compound interest basis. The premium is, therefore, not an earning, an item of income, but is an offset to the excess bond interest.* The portion of it applicable to each period represents the excess interest which deducted from the bond interest shows the real or effective cost of the money borrowed and to be paid back.

> Thus, the bond interest rate based on the money actually received, i. e., par plus premium, is exactly the same as the market or effective rate on par. In other words, the corporation is paying for its actual borrowings simply the current market rate of interest.
>
> It is therefore incorrect to show in the books the cost of the loan at any other figure than the effective interest. The actual periodic payment of interest is, however, at the bond interest rate. This must be brought down to the effective rate by application to it of a portion of the premium which represents the sum paid for the privilege of receiving the higher rate of interest. Similarly, bonds are marketed at a discount when the bond interest rate is lower than the market rate prevailing on similar security at the time the bonds are floated. This may be looked upon as a payment by the company in lump sum to compensate a purchaser for the difference in the income on the bond and what he might obtain on the open market. The discount should be applied, therefore, periodically to bring the cost of the loan up to its true figure, viz, the market or effective rate. (Italics ours.)

Similarly, in Hatfield, "Modern Accounting," it is stated (pp. 187–188):

> As shown in discussing investments, the premium paid on a bond is virtually the price paid for the privilege of receiving nominal interest at a rate higher than the market

rate. *Viewing the transaction from the borrower's point of view, the premium received is, therefore, a lump payment made in return for the obligation to pay an excessive rate of interest during the life of the bond.* If the credit of the company and the conditions of the market would have enabled the company to issue a five per cent twenty-year bond at par, its six per cent bond, running at the same time, should sell at approximately 112.46. This premium of 12.46 is, therefore, the present value of the annuity of one per cent which the company must pay for 20 years but *the interest installments as paid are normally and properly charged off as an expense and consequently the 12.46 per cent should be spread over all the years during which the interest is thus paid, in order properly to equalize the profits of the several years.* The correct entry, therefore, is to credit the premium received to "Premium on Bonds Issued" a part of which is annually written off to offset the interest paid the bondholders * * *.

Exactly the same principle applies to bonds issued at a discount, just as the same principle applies to bonds bought below par. The discount should appear at first among the assets, but should gradually be written off as the years pass, thus making the annual charge to interest correspond to the real rather than the nominal rate paid. (Italics ours.)

Excerpts from other accounting authorities similar to the foregoing are set forth in the Appendix, pp. 50–52, *infra*.

The views as to the essential nature of bond premiums and bond discounts set forth in the above quotations are reflected in the regulations of the Treasury Department. Thus, Article 848 of Regulations 45, issued under the Revenue Act of 1918, and Article 848 of Regulations 62, issued under the 1921 Act, dealing with the invested-capital provisions, provided:

> ART. 848. *Surplus and undivided profits: discount on sale of bonds.*—Discount allowed on the sale of bonds is in effect an advance on account of interest so that the effective rate of interest in such a case is equal to the sum of the nominal rate plus the rate necessary to amortize the discount over the life of the bonds. Where, under incorrect accounting practices, the discount on bonds has been charged to a property account or otherwise incorrectly carried as an asset, and is so reflected in the surplus account, it is necessary in computing invested capital to make an adjustment in respect of such discount.

In the instant case the petitioner's liability to pay excess interest, by reason of the issuance of the bonds at a premium, continued throughout 1921. The question at issue, as the Government views the case, is whether that part of the "interest" payment, so called, made in 1921, which rep-

resented a repayment in part of the premium, could properly be claimed by petitioner as a deduction from its gross income for that year as a cost or expense properly attributable to the earning of that income. We contend that this was not a proper deduction, and that in determining the petitioner's true net income for 1921 it was necessary, as was done by the petitioner on its books, to offset the excess interest paid in that year—which represented a repayment in part of the premium—by the amortized portion of the premium applicable to that year.

By Section 234 (a) (2) of the Revenue Act of 1921 the petitioner was allowed to deduct from its gross income "All *interest* paid or accrued within the taxable year on its *indebtedness.*" The real "indebtedness" of the petitioner on the bonds here in question is the aggregate of the face value of the bonds. The interest on this indebtedness, which is clearly what the statute contemplates, is interest thereon at the *effective rate,* or that rate at which the bonds would have been sold at par rather than interest at the *nominal rate* set forth in the bonds themselves, the latter rate in reality, under proper accounting rules, representing in part a return of the borrowed capital. Accordingly, we contend that the "interest" payable on the petitioner's bonds in excess of the effective rate is not interest on indebtedness within the meaning of the statute, but simply a repayment in accurately computed yearly installments on a compound interest basis

of the money obtained as a premium when the bonds were issued; and the time over which the bonds are to run is as much a factor in the repayment of this money as the rate of excess interest itself. We submit that any sum, though called interest, which represents in fact a repayment of bond premium, and thus a repayment of part of the borrowed capital, is not a true cost or expense attributable to the earning of income. Nor is it interest on the petitioner's indebtedness, and accordingly the statute does not permit its deduction from gross income. See 41 Yale L. J. 280.

II

THE PETITIONER'S BOOKS, KEPT ON THE ACCRUAL BASIS, ACCURATELY REFLECTED ITS TRUE INCOME FOR 1921, AND THE COMMISSIONER PROPERLY COMPUTED THE TAX ON THE BASIS OF THE NET INCOME AS SHOWN BY SUCH BOOKS

In compliance with the accounting classifications of the Interstate Commerce Commission the petitioner, on its books and in its annual report to the Commission, included as income for 1921 the sum of $6,960.64, being the proportion of the bond premium properly attributable to that year.[5] (R. 45, 65.) Upon comparing the petitioner's tax return for 1921 with its books, the Commissioner found

[5] The Board of Tax Appeals found that for each year after 1914 the petitioner reported a ratable proportion of the bond premiums to the Interstate Commerce Commission as income. (R. 45.) The Board also found that "On its books in each such year petitioner credited such proportion of the premiums to profit and loss account (a surplus account) and

that while the petitioner in its return had claimed as a deduction from gross income the full amount of the asserted "interest" paid on its bonds (R. 65), it had failed in its return to add to its gross income that part of the bond premiums corresponding to the excess interest which the bonds called for in 1921. Accordingly, the Commissioner added the sum of $6,960.64 to the petitioner's gross income for 1921. (R. 65.) In making the necessary adjustment the Commissioner might have refrained from adding the item of $6,960.64 to the petitioner's gross income, as the petitioner did in its 1921 tax return, but it would then have been necessary to reduce by $6,960.64 the amount of the "interest paid" deduction claimed in the petitioner's return.

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not to its income account." (R. 45.) Since under the Interstate Commerce Act the petitioner was required to keep its books pursuant to the accounting classifications of the Commission, it is difficult to reconcile these findings, except upon the assumption that the petitioner failed to follow the accounting classifications of the Commission, which plainly required the petitioner to credit the amounts in question to its income account. (See pp. 19, 45, 49, *infra*.) But for purposes of the income tax the effect of the act of the petitioner in crediting the amounts in question to its profit and loss account, a *surplus* account, was substantially the same as if such amounts had been credited immediately to its income account. If such amounts had been credited by the petitioner directly to its income account, they would thereupon have been reflected in its profit and loss account, since the Commission's classifications prescribed that "The net balance of income (or loss) shall be carried to Profit and Loss." (P. 46, *infra*.) By crediting the amounts in question directly to profit and loss, in plain violation of the accounting rules of the Commission, the petitioner thus merely omitted one step in the usual and prescribed accounting procedure.

But since the same result, *so far as the amount of taxable net income is concerned,* was reflected by the petitioner's books, kept on the accrual basis, the Commissioner, as required by the statute, adopted the method of accounting employed by the petitioner because it reflected the petitioner's true income.

Section 212 (b) of the Revenue Act of 1921, p. 40, *infra,* made applicable to corporations by Section 232, p. 40, *infra,* required that—

> *The net income shall be computed* upon the basis of the taxpayer's annual accounting period * * * *in accordance with the method of accounting regularly employed in keeping the books of such taxpayer;* but * * * if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. (Italics ours.)

The accrual method of reporting income employed by the petitioner was authorized by Section 213 (a) of the Revenue Act of 1921, pp. 40–41, *infra,* which provided with respect to gross income that—

> The amount of all such items * * * shall be included in the gross income for the taxable year in which received by the taxpayer, *unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period:* * * * (Italics ours.)

The form of General Balance Sheet Statement prescribed by the accounting classifications of the Interstate Commerce Commission for steam railroads, pursuant to which the petitioner was required to keep its accounts, provided (pp. 44–45, *infra*):

> When any issue of funded debt is sold at a premium or issued for a consideration the actual money value of which, at the time of the sale of the funded debt, is greater than the par value of the securities sold and accrued interest thereon, if any, the premium so realized should be credited to a ledger account provided for discounts and premiums on the class of funded debt sold. * * * At or before the close of any fiscal period there should *be credited to the Income of that period* (and debited to the Discounts and Premiums accounts in which the premium is carried) such proportions of the premiums on outstanding debt obligations as may be applicable to that period. This proportion may be determined according to a rule the uniform application of which throughout the interval between the date of sale and the date of maturity of the debt will extinguish the premium at which such debt was sold. (Italics ours.)

It will be seen that the Commissioner computed the petitioner's net income for 1921 on the basis of the method of accounting which the petitioner then regularly employed in keeping its books, and which

was necessarily in accordance with rules of the Interstate Commerce Commission designed to reflect accurately the financial condition of the company. That the particular accounting procedure followed by the petitioner was forced upon it by reason of the regulations of the Interstate Commerce Commission is wholly immaterial if, as we contend, the accounting procedure followed by the petitioner accurately reflected its net income. Clearly the Government's right to the correct tax is not to be defeated by the fact that the taxpayer's true income for tax purposes was reflected by a system of bookkeeping which had been found necessary to show its true income for rate-making or other purposes.

From the foregoing it is clear that in form the Commissioner credited the petitioner's gross income for 1921 with the part, applicable to that year, of the premiums which it had received on the sale of its bonds in the years between 1895 and 1904, and thus made the petitioner's return conform to its books. In substance, this amounted to nothing more than one method of eliminating from the petitioner's deductions from gross income in 1921 the excess interest carried by the bonds. The repayment of capital in the form of excess interest is not an expense attributable to the earning of income for the taxable year. The Commissioner's object was to distinguish repayment of capital from deductible expense, just as it is necessary "to distinguish capital previously existing from income taxable under the act." *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, 188.

III

THE COMMISSIONER WAS REQUIRED BY THE REGULATIONS TO PRORATE OR AMORTIZE THE PREMIUMS OVER THE LIFE OF THE BONDS. NO CONSTITUTIONAL OBJECTION ARISES FROM THE FACT THAT THE BOND PREMIUMS HERE IN QUESTION WERE RECEIVED PRIOR TO MARCH 1, 1913

Article 545 of Regulations 62, pp. 41–43, *infra*, provided:

> If bonds are issued by a corporation at a premium, the net amount of such premium is gain or income which should be prorated or amortized over the life of the bonds.

The petitioner concedes that these regulations are valid but contends that they are not applicable to a case where, as in the instant case, the premiums were received prior to March 1, 1913. (Pet. Br. 10.) The Government contends that there is no constitutional objection to applying the regulations to premiums received prior to the effective date of the Sixteenth Amendment.

Calling something income does not make it such. See *Eisner* v. *Macomber*, 252 U. S. 189, 206. While concededly the regulations speak of a premium received on the issuance of a corporate bond as "gain or income," in reality, as set forth in Point I, *supra*, such premium is not income any more than the receipt of borrowed money is income. It is, as we have shown, nothing more than a lump payment of money which is to be repaid in installments

in the form of excess interest running over the life of the bond. It is properly *treated as gross income* only for the purpose of offsetting that part of the excess interest, carried by the bond, which represents a return of the borrowed capital, and which is not properly deductible from gross income as "interest paid." But while the phrasing of the regulations may be inept, the intention to amortize bond premiums over the life of the bonds is plain, and the result of the application of the regulations is to reflect the true income of the taxpayer who issues bonds at a premium.

The accounting mechanics authorized by the statute and adopted by the Commissioner are embodied in the accrual system of accounting on which the books of the petitioner were kept. The object to be accomplished was not to tax any part of the premiums as income, but to prevent the deduction from gross income of sums representing a repayment in part of those premiums. Because the books of the taxpayer showed as a charge, deductible from gross income, the whole of the asserted "interest" carried by the bonds as issued, the logical, and indeed the scientific, method of bringing the account to a proper balance was not to change or alter the entries showing interest paid, and thus lead perhaps to confusion as to the meaning of the entries, but to enter as a compensating item on the other side of the account, as income, the exact part of the interest on the bonds which represented a repayment in part of premiums. In this manner the

books were not only kept in proper balance, but the effect was to exhibit true income by preventing a deduction for the taxable year which was not in any sense attributable to the earning of income for that year.

It is thus seen that the gist of the petitioner's complaint is directed at a mere bookkeeping entry, *the true effect of which was merely to prevent an improper deduction from gross income.* What was done was not, therefore, in a field beyond the power of Congress to enter, but in one where its authority stands unchallenged. *Brushaber* v. *Union Pac. R. R. Co.,* 240 U. S. 1; *Stanton* v. *Baltic Mining Co.,* 240 U. S. 103; *Kentucky Tobacco Products Co.* v. *Lucas,* 5 F. (2d) 723 (W. D. Ky.). Standing upon the mere form of the bookkeeping entries, the taxpayer insists that the tax demanded of him is beyond the power of Congress to levy without apportionment. Looking at the substance of what was done, and disregarding the mere form of the entries which reflect that substance, the Government claims that no constitutional question is involved.

In *Commissioner* v. *Old Colony Railroad Co.,* 26 F. (2d) 408, 410 (C. C. A. 1st), which involved the same taxpayer and the same bonds, the court below seems to have been misled by what it regarded as an established fact, that "these premiums when received were regarded and treated as capital and expended in the improvement of its road." There was nothing in the record in that case to support this statement. But even if the

premiums were so treated and used, that fact offers no argument against the respondent's contention herein. On the contrary, it supports it. The capital which was provided *by the premiums* was, just like the rest of the money received upon the sale of the bonds, borrowed capital; but, under the contract of borrowing, this particular part of the borrowed capital was to be repaid during the life of the bonds by annual payments in the form of excess interest. That part of the excess interest for 1921 which represented a repayment of premiums was thus a return of borrowed capital and was not deductible from gross income. The Commissioner was clearly right in excluding such deductions, and this is all that he did.

The court below did not consider that its decision in the instant case was inconsistent with its previous opinion in 26 F. (2d) 408. Speaking of the earlier case, the court said (R. 75):

> The court's attention was not called to the fact that the profit made in the early years was not being taxed, but that it was being used only to determine the expense for the year 1921 of the payment of interest on the bonds. This is not a tax but an allocation, under proper accounting methods for books kept on the accrual basis, of the expense chargeable to the year 1921. See *Chicago, Rock Island & Pacific Ry. Co.*, 13 B. T. A. 989, 1029.

Assuming as a matter of course that it was permissible to limit directly the deduction allowed for

interest,[6] it seems clear that the manner in which this was accomplished is unimportant. Cf. *Block* v. *Hirsh*, 256 U. S. 135, 158. Moreover, once it be understood that the Commissioner was taking the amortized portion of the bond premium applicable to 1921 into consideration only for the purpose of determining the petitioner's interest deduction for 1921, it becomes quite immaterial whether bond premiums constitute income or not, since it is competent for Congress to consider, in the measure of a tax, that which it may not tax directly. Thus, either the Federal or State government may include the tax-exempt bonds of the other in computing excise taxes on corporations for the privilege of doing business in corporate form. *Provident Institution* v. *Massachusetts*, 6 Wall. 611; *Society for Savings* v. *Coite*, 6 Wall. 594; *Hamilton Company* v. *Massachusetts*, 6 Wall. 632; *Home Ins. Co.* v. *New York*, 134 U. S. 594; *Flint* v. *Stone Tracy Co.*, 220 U. S. 107. Likewise, receipts from exports may properly be included in computing a Federal tax. *Peck & Co.* v. *Lowe*, 247 U. S. 165; *Barclay & Co.* v. *Edwards*, 267 U. S. 442. Similarly, the measure of a State tax may include receipts from interstate commerce. *U. S. Glue Co.* v. *Oak Creek*, 247 U. S. 321; *Shaffer* v. *Carter*, 252 U. S. 37; *Underwood T'writer Co.* v. *Chamberlain*, 254 U. S. 113. Congress may tax State banks upon the aver-

[6] See for instance, Section 12 (a) Third of the Revenue Act of 1916, c. 463, 39 Stat. 756, 767. And see cases cited at p. 23, *supra*.

age amounts of their deposits and include for this purpose deposits of State funds. *Manhattan Company* v. *Blake,* 148 U. S. 412.

Upon like principles we think that the inclusion by the Commissioner of the amortized portion of the premiums in petitioner's gross income, rather than the direct reduction of the interest allowance, raises no constitutional question. It is wholly immaterial, therefore, that the premiums in question were received prior to the effective date of the Sixteenth Amendment. Neither that fact nor any other fact shown by the record raises any question of the taxing powers of Congress under the Constitution.

IV

THE PRINCIPLE FOR COMPUTING NET INCOME WHICH THE COMMISSIONER EMPLOYED IN THE INSTANT CASE HAS BEEN APPROVED BY THE COURTS AND BY THE BOARD OF TAX APPEALS

The Board of Tax Appeals in the instant case allowed itself to be misled, by the form in which the bookkeeping entry was made, into a disregard of what in substance the entry accomplished. The Board has since rectified its error, and now holds that both bond premiums and bond discounts must be amortized over the life of the bonds, regardless of the date of the issuance of the bonds.

The ruling of the Board in the instant case was predicated upon its prior ruling as to the petitioner's tax liability for 1920, reported in 6 B. T. A. 1025, where it was held that the premiums received

upon the sale of the bonds in question could not be allocated over the life of the bonds and an allocated part thereof included in the petitioner's gross income each year during the life of the bonds. That decision of the Board was affirmed by the court below in *Commissioner* v. *Old Colony Railroad Co.* 26 F. (2d) 408, upon the ground that the premiums became part of the petitioner's capital prior to the enactment of the Sixteenth Amendment and could not be taxed as income thereafter.

In its previous decision in 6 B. T. A. 1025, *supra*, the Board intimated that if the bonds had been sold at a discount it would have refused to permit the amortization of such discount. Later, in *Chicago, Rock Island & Pacific Ry. Co.* v. *Commissioner*, 13 B. T. A. 988, it characterized as dictum its statement with reference to discounts in 6 B. T. A. 1025, and allowed the amortization of discounts on bonds sold prior to March 1, 1913.[1] It distinguished the *Rock Island* case from its decision in the previous *Old Colony* case, as follows (pp. 1029–1030):

> What is income is controlled by the Constitution, while *deductions are a statutory concept*. In the years before us, the peti-

[1] Upon petition for review of other issues involved in this case the decision of the Board was affirmed in *Chicago, Rock Island & Pacific Ry. Co.* v. *Commissioner*, 47 F. (2d) 990, certiorari denied, October 12, 1931, No. 78, October Term, 1931. See pp. 34–35, *infra*.

tioner was on an accrual basis for the reporting of income, not only because that was the system necessary to reflect true income, but because the Interstate Commerce Commission required such a basis. Income realized before the adoption of the Sixteenth Amendment may not thereafter be taxed, *but as concerns deductions from income, the same rule does not necessarily apply.* (Italics ours.)

In *Chicago & Northwestern Ry. Co.* v. *Commissioner,* 22 B. T. A. 1407, the Board, following its decision in the first *Old Coloney* case, held that the amortized portion of premiums on bonds issued prior to March 1, 1913, should not be included in the taxpayer's gross income of 1920, but, departing from its decision in the *Old Coloney* case, held that the amortized portion of premiums on bonds issued subsequent to March 1, 1913, should be included in gross income of subsequent years. In *Fall River Electric Light Co.* v. *Commissioner,* 23 B. T. A. 168, the Board held that the Commissioner should not increase taxable income by reducing deductions allowed for interest by a proportionate amount of the premiums received on the sale of bonds in 1925, but that the premiums were income and should be amortized over the life of the bonds.

On October 21, 1931, the Board overruled its earlier decisions and followed the decision of the court below in the instant case. *Connecticut &*

Passumpsic Rivers R. R. Co. v. *Commissioner*, 24 B. T. A. 394, 400. In that case the Board said:

> In the light of the later pronouncement of the same court upon this question, we sustain the Commissioner's regulation and *hold that an aliquot part of the premiums upon bond issues is to be included in the gross income regardless of the date of issue.* (Italics ours.)

Although the court in the instant case held that the deduction for interest paid should be reduced by the aliquot portion of the bond premium allocable to the taxable year, the Board in the case cited said that—

> * * * the result is the same if the aliquot portion of the premium be included in the gross income and the taxpayer is permitted to deduct as an expense the total interest paid on the bond issue during the taxable year.

In *Western Maryland Ry. Co.* v. *Commissioner*, 33 F. (2d) 695 (C. C. A. 4th), the court, following the decision of the Board in the *Rock Island* case, 13 B. T. A. 988, held that where bonds were sold at a discount between 1904 and 1911, such discount could be amortized over the life of the bonds and a proportionate part thereof deducted each year as accrued interest from gross income under Section 234 (a) (2) of the Revenue Act of 1918.

The amortization of bond discounts over the life of the bonds, even where the bonds were issued

prior to 1913, is thus clearly established by decisions of the Board and the courts. But, keeping in mind the nature of a bond premium, it is obvious that, where the taxpayer's books are kept on the accrual basis, the treatment thereof in computing net income should differ in no essential regard from the treatment of bond discounts. If in the case of bond discounts the nominal interest must be corrected to the effective interest, the same reasoning requires the correction of the nominal interest to effective interest in the case of bond premiums. The purpose in either case is to conform the "interest paid" deduction from gross income to interest calculated at the *effective rate* on the amount of money borrowed, regardless of the manner of its receipt or payment.

What the Board of Tax Appeals at first failed to appreciate was that in cases of bond discounts, as well as in cases of premiums, it was in fact dealing with the *same* "statutory concept," i. e., *deductions from gross income.* The application is somewhat different in the two cases but the principle is the same. The object to be obtained in either case is the deduction from gross income of the full amount of interest at the effective rate on the indebtedness created by the issuance of the bonds. This purpose necessarily excludes the deduction as interest, in the case of bonds sold at a premium, of that part of the so-called annual interest payment which is in essence a repayment of money received in the form of premiums. The regulations provide for the amortization of both premiums and discounts,

and a large number of tax settlements have been disposed of on that basis.

In *Galatoire Bros.* v. *Lines,* 23 F. (2d) 676, 677, the Circuit Court of Appeals for the Fifth Circuit had before it a case in which the taxpayer, as consideration for the lease of a certain building for restaurant purposes, had promised to pay the lessor $250 per month during the life of the lease, plus fifty per cent of the profits of the restaurant during the year 1917, and, also, to furnish the lessor and his family with board during that year. The question presented was whether the taxpayer could deduct from gross income for 1917 the fifty per cent of the profits for that year payable to the lessor, as well as the cost of furnishing board to him and his family during that year, or whether these sums should be prorated over the life of the contract and only that part thereof properly applicable to the year 1917 allowed as a deduction. The Government contended for the pro rata deduction, and the court, upholding this contention, said:

> The expenditures in question being in part a consideration for the use of the rented premises after the year 1917, the whole thereof cannot properly be considered "necessary expenses actually paid in carrying on any business or trade" during that year, and only the part thereof properly attributable to the process of earning income during that year was deductible from the gross income for that year.

In *United States* v. *Anderson* and *United States* v. *Yale & Towne Mfg. Co.*, 269 U. S. 422, 440, this Court held that a taxpayer's income for a given taxable year could not be correctly determined without deducting from its gross income for such year the true cost and expenses attributable to the production of income during that year. Cf. *American National Co.* v. *United States*, 274 U. S. 99; *Duffy* v. *Central R. R.*, 268 U. S. 55.

Having in mind the true nature of premiums, the value of these cases as precedents is not lost by reason of the fact that they deal with matters occurring after March 1, 1913.

There are no authorities contrary to the Government's contention. *New York Life Insurance Co.* v. *Edwards*, 271 U. S. 109; *Baldwin Locomotive Works* v. *McCoach*, 221 Fed. 59 (C. C. A. 3d); and *Chicago & Alton Railroad Co.* v. *United States*, 53 C. Cls. 41, are not in conflict with the instant case, since the first case involved the Revenue Act of 1913, and the last two cases involved the Corporation Excise Tax Act of 1909, both of which recognized only the cash receipts and disbursements basis for filing tax returns. Another vital distinction between the *New York Life Insurance Co.* case and the instant case is that the former involved the amortization of premiums on bonds of others purchased by the taxpayer, whereas the instant case involves the amortization of premiums on bonds issued by the petitioner. That case is further differentiated from this case by the fact that the

Court there considered only the question whether annual amortization could be taken, not as an offset against interest received, but as a loss "actually sustained within the year." (See *C., R. I. & P. Ry. Co.* v. *Commissioner,* 13 B. T. A. 988, 1033.)

Lynch v. *Turrish,* 247 U. S. 221; *Southern Pacific Co.* v. *Lowe,* 247 U. S. 330; *Doyle* v. *Mitchell Bros. Co.,* 247 U. S. 179; *Hays* v. *Gauley Mt. Coal Co.,* 247 U. S. 189; *Merchants' L. & T. Co.* v. *Smietanka,* 255 U. S. 509; and *Goodrich* v. *Edwards,* 255 U. S. 527, which were cited by the court below in the 1920 case (26 F. (2d) 408), are authority for the proposition that Congress, under the Sixteenth Amendment, can not tax as income a gain which accrued prior to the effective date of that Amendment, even though it was not realized until after that date. But they are not authority for the proposition that where prior to that date a corporation has sold its bonds at a premium and assumed an offsetting obligation to pay excess interest throughout the life of the bonds, Congress may not exclude that part of the annual interest payment which represents a repayment of premiums from the interest deduction it allows to be made from gross income. Nor do these cases hold that where, as in this case, the portion of the annual interest payment representing the repayment of premiums has been deducted as interest, Congress may not require its addition to gross income so as to offset its improper deduction as interest. We know of no decision of this Court which denies

the right of the Commissioner to make such adjustments.

The petitioner contends that the decision of the court below in the instant case is inconsistent with that in *Chicago, R. I. and P. Ry. Co.* v. *Commissioner*, 47 F. (2d) 990 (C. C. A. 7th), certiorari denied, October 12, 1931, No. 78, October Term, 1931. In that case it was held, *inter alia*, that a pro rata part of expenses incurred in the years 1904 to 1908 in connection with the issuance and sale of certain long-term bonds could not be deducted in the taxpayer's income-tax returns for the years 1916 to 1919, inclusive. Unlike the instant case, that case involved Section 234 (a) of the Revenue Act of 1918, which allowed a deduction from gross income of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business," and a similar section in the Revenue Act of 1916, and the Government argued that the expenses in question were not "ordinary and necessary" expenses, that they were not paid or incurred during the taxable years in question, and that they were not incurred "in carrying on any trade or business," since they were not incidental to the current production of income.

Apart from the difference in the applicable sections of the statute, the question of allowing such expenses as were involved in the *Rock Island* case to be amortized and deducted over the life of the bonds is totally different from the question of allowing a pro rata part of amortized bond premiums to

be offset against interest deductions. There is no relation between such expenses and the calculation of interest. They do not enter into the transaction between the lender and the borrower at all, whereas the premium is paid by the lender for the obligation of the taxpayer to pay a rate of interest higher than the rate at which the bonds could be sold on the market at par, upon the assurance that the premium will be repaid dollar for dollar in annual installments and in the form of excess interest stipulated for on the face of the bonds. For taxation purposes the problem reduces itself to the question of allowing the taxpayer to deduct so much of the interest paid to bondholders as equals the effective interest rate, the balance constituting a repayment of the premium. Thus, while the Circuit Court of Appeals for the Seventh Circuit relied upon the first *Old Colony Railroad Company* case in deciding the question of the deductibility of expenses incurred in selling bonds prior to March 1, 1913, there is not in fact a conflict between the *Rock Island* case and the case at bar. In this connection attention is called to the fact that amortization of bond discount, which is more closely analogous to bond premium than the expenses involved in the *Rock Island* case, had been allowed to the Chicago, Rock Island and Pacific Railway Company in the case in question and its allowance was not questioned. See also *Western Maryland Ry. Co.* v. *Commissioner*, 33 F. (2d) 695 (C. C. A. 4th), *supra*.

V

THE CONTENTION OF THE GOVERNMENT IS NOT AFFECTED BY THE FACT THAT THE PETITIONER'S LESSEE WAS OBLIGATED TO PAY THE PRINCIPAL OF AND INTEREST ON THE BONDS IN QUESTION

In Point III of the brief in support of the petition for certiorari, the petitioner argues that even if the Government's contention—that the petitioner is entitled to a deduction for interest paid at the effective interest rate rather than at the nominal interest rate—were sound it would not apply to the instant case, where the bonds were issued at a premium by a lessor corporation under a long-term lease which provided that the lessee should pay the interest fixed by the bonds and redeem them at maturity. The contention of the petitioner apparently is that the bond premiums, whether used for improvements of the railroad or to pay its prior obligations which had been assumed by the lessee, inured primarily to the benefit of the lessee and that the petitioner would secure no benefit therefrom until termination of the lease in 1992. Accordingly, it is argued that in any event the Government would not be "justified *in treating as income*" to the petitioner in 1921 more than "the present value in that year of the right to $6,960.64 receivable in 1992, which on a 4% compound discount basis would be about $445." We submit that the petitioner's contention is wholly without merit.

In the first place it entirely misconstrues the Government's argument, which is that the sum of

$6,960.64 in question *is not income and is not taxed as such.* Accordingly, there is no necessity for establishing that it possesses any of the incidents of income. It is true that the Commissioner, in the petitioner's tax return, included the amount in question as *gross income,* but that was only an accounting device, suggested by the petitioner's own books of account, for determining the correct amount of the statutory interest deduction.

Moreover, it is not true that the bond premium "could not benefit the lessor [petitioner] until the termination of the lease." The payment of the interest due on the petitioner's bonds by its lessee in reality constitutes additional rent on which the petitioner, as lessor, is liable to pay income taxes. *United States* v. *Boston & Maine Railroad,* 279 U. S. 732; *Boston Terminal Co.* v. *Gill,* 246 Fed. 664 (C. C. A. 1st). But although the payment by the lessee of the petitioner's interest obligations on the bonds constitutes gross income of the petitioner, the petitioner—being obligated to pay the bonds and the interest thereon—is entitled to a deduction for the payment of such interest. *Boston Terminal Co.* v. *Gill, supra.* So far as the "interest" payable on the bonds represents true interest, and not the repayment of bond premium, the two transactions exactly offset each other, and no tax results for the petitioner. As far as benefit to the petitioner is concerned, the petitioner is benefited just as much by the lessee's payment of that part of the "inter-

est" payable on the bonds which represents a part repayment of the bond premium, as by the lessee's payment of that part of the annual "interest" payment which represents true interest. In each case the petitioner is benefited by the discharge of its legal obligations.

Furthermore, the petitioner must be taken as having received the benefit of the bond premiums in the instant case, since it received the entire proceeds of the bonds. And even if the bond proceeds were used for improvements of the leased property, which the petitioner can not use until 1992, or for the payment of its prior indebtedness, which was assumed by its lessee, the petitioner in reality began receiving the actual benefit of the premiums immediately upon the issuance of the bonds by reason of the payment by the lessee of rent in excess of the effective interest rate.

CONCLUSION

The method adopted by the Commissioner in computing the petitioner's 1921 net income was in accordance with principles of accounting recognized as sound by leading authorities and by the Interstate Commerce Commission. It reflected accurately the petitioner's financial condition and net income, and was the method actually used by the petitioner in keeping its books and making its reports to the Commission. It was, in essence, in accordance with the Treasury Regulations uniformly followed since the enactment of the Revenue Act of

1918, and applied to the billions of dollars of outstanding indebtedness of American railroads upon long-term obligations. (See Thirty-First Annual Report of Interstate Commerce Commission on the Statistics of Railways in the United States for the year ending December 31, 1917, pp. 34–36, 54–56.) Under such circumstances the determination of the Commissioner should not be disturbed.

Moreover, unless the Commissioner's theory as to the treatment of bond premiums is adopted, it would seem that a corporation, by selling its bonds at a high nominal interest rate so as to produce a premium, could reduce its taxable net income by the amount of the premium and to that extent escape taxation.

The judgment below should be affirmed.

Respectfully submitted.

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APPENDIX

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 252, 254:

SEC. 212. (b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but * * * if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. * * *

SEC. 230. (a) That * * * there shall be levied, collected, and paid for each taxable year upon the net income of every corporation a tax * * *

SEC. 232. That in the case of a corporation subject to the tax imposed by section 230 the term "net income" means the gross income as defined in section 233 less the deductions allowed by section 234, and the net income shall be computed on the same basis as is provided in subdivision (b) of section 212 or in section 226.

SEC. 233. (a) That in the case of a corporation subject to the tax imposed by section 230 the term "gross income" means the gross income as defined in sections 213 * * *

SEC. 213. That * * * the term "gross income"—

(a) Includes gains, profits, and income derived from * * * businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, * * * or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items * * * shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; * * *.

SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions—

(1) All the ordinary and necessary expenses paid or incurred during the taxable year * * *;

(2) All interest paid or accrued within the taxable year on its indebtedness * * *.

Treasury Department Regulations 62, issued under the Revenue Act of 1921:

ART. 545. *Sale and retirement of corporate bonds.*—(1) (a) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. (b) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. See section 234 of the statute and article 563. (c) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price

or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year.

(2) (a) If bonds are issued by a corporation at a premium, the net amount of such premium is gain or income which should be prorated or amortized over the life of the bonds. (b) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price minus any amount of premium already returned as income, the excess of the purchase price over the issuing price minus any amount of premium already returned as income (or over the face value plus any amount of premium not yet returned as income) is a deductible expense for the taxable year. (c) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price minus any amount of premium already returned as income, the excess of the issuing price minus any amount of premium already returned as income (or of the face value plus any amount of premium not yet returned as income) over the purchase price is gain or income for the taxable year.

(3) (a) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. (b) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year.

(c) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted) over the purchase price is gain or income for the taxable year.

Article 544 of Treasury Department Regulations 45, issued under the Revenue Act of 1918, Article 545 of Regulations 65, issued under the Revenue Act of 1924, Article 545 of Regulations 69, issued under the Revenue Act of 1926, and Article 68 of Regulations 74, issued under the Revenue Act of 1928, contain substantially the same language as Article 545 of Regulations 62 above quoted.

Treasury Department Regulations 62 also provide:

ART. 848. *Surplus and undivided profits: discount on sale of bonds.*—Discount allowed on the sale of bonds is in effect an advance on account of interest, so that the effective rate of interest in such a case is equal to the sum of the nominal rate plus the rate necessary to amortize the discount over the life of the bonds. Where, under incorrect accounting practices, the discount on bonds has been charged to a property account or otherwise incorrectly carried as an asset, and is so reflected in the surplus account, it is necessary in computing invested capital to make an adjustment in respect of such discount. See article 563.

Treasury Department Regulations 45, Article 848, is in substantially the same language as Article 848 of Regulations 62.

[Excerpts from accounting orders and classifications of the Interstate Commerce Commission]

The form of General Balance Sheet Statement prescribed by the Interstate Commerce Commission for steam roads, in accordance with Section 20 of the Act to Regulate Commerce, First Revised Issue (effective June 15, 1910) provides (pp. 23, 31):

> *Deferred debit items.*—B 20 (b) Unextinguished Discount on Funded Debts: If the net of the balances in the Discounts and Premiums accounts for all classes of funded debt sold is a debit balance, the amount should be included in this account. At or before the close of each fiscal period, there should be charged to Income (and credited to the Discounts and Premiums accounts in which the discount is carried) such proportions of the discount on outstanding debt obligations as may be applicable to that period. This proportion should be determined according to a rule the uniform application of which throughout the interval between the date of sale and the date of maturity will extinguish the discount on funded debt. In order that the discount may be extinguished earlier the company may, at its option, charge to Profit and Loss all or any portion of the discount on funded debt remaining at any time unextinguished; but the charge to Income for any period must not exceed the proportion applicable to that period and a charge should be made for each period so long as any portion of the discount remains unextinguished.
>
> NOTE A.— * * *.
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> NOTE B.—In no case should discount on securities be charged to or included in any

account as a part of the cost of acquiring any property, tangible or intangible.

* * * * *

Deferred credit items.—B. 144 Unextinguished Premiums on Outstanding Funded Debt: When any issue of funded debt is sold at a premium or issued for a consideration the actual money value of which at the time of the sale of the funded debt is greater than the par value of the securities sold and accrued interest thereon, if any, the premium so realized should be credited to a ledger account provided for discounts and premiums on the class of funded debt sold. (See account B 20.) If the net of the balances in the Discounts and Premiums accounts for all classes of funded debt sold is a credit balance, the amount should be included in this account. At or before the close of any fiscal period there should be credited to the Income of that period (and debited to the Discounts and Premiums accounts in which the premium is carried) such proportions of the premiums on outstanding debt obligations as may be applicable to that period. This proportion may be determined according to a rule the uniform application of which throughout the interval between the date of sale and the date of maturity of the debt will extinguish the premium at which such debt was sold.

The Classification of Income, Profit and Loss, and General Balance Sheet Accounts for Steam Roads prescribed by the Interstate Commerce Commission, effective July 1, 1914, provides (pp. 11, 13, 15, 18, 19, 23, 29, 35, 37, 39, 40):

INCOME ACCOUNTS

* * * * *

SPECIAL INSTRUCTIONS

1. *Income accounts defined.*—Income accounts are those designed to show, as nearly as practicable, for each fiscal period, the total amount of money that a carrier becomes entitled to receive for services rendered, the returns accrued upon investments, the accrued costs paid or payable for the services rendered by it, the losses sustained by it, the amounts accrued for taxes, for use of moneys and for use of properties of others, and the appropriations made from income during the period. The net balance of income (or loss) shall be carried to Profit and Loss.

* * * * *

I. CREDITS

* * * * *

517. RELEASE OF PREMIUMS ON FUNDED DEBT.

This account shall include, during each fiscal period, such proportion of the premiums on outstanding funded debt as may be applicable to the period. This proportion shall be determined in accordance with special instructions for balance-sheet accounts, section 3.

* * * * *

II. DEBITS

* * * * *

548. AMORTIZATION OF DISCOUNT ON FUNDED DEBT.

This account shall be charged during each fiscal period with the proportion of the dis-

count and expense on funded debt obligations applicable to that period. This proportion shall be determined according to a rule the uniform application of which through the interval between the date of sale and the date of maturity will extinguish the discount and expense on funded debt. The charge to this account for any period must not be either greater or less than the proportion of the balance remaining unamortized applicable to that period so long as any portion of the discount and expense remains unextinguished. (See special instructions for balance-sheet accounts, section 3.)

NOTE.—The accounting company may, at its option, charge to profit and loss account No. 617, "Debt discount extinguished through surplus," all or any portion of the discount and expense on funded debt remaining at any time unextinguished.

* * * * *

PROFIT AND LOSS ACCOUNTS

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617. DEBT DISCOUNT EXTINGUISHED THROUGH SURPLUS.

This account shall include appropriations of surplus made, at the option of the accounting company, to reduce or extinguish the discount and expense on funded debt. (See income account No. 548, "Amortization of discount on funded debt," and balance-sheet account No. 725, "Discount on funded debt.")

* * * * *

GENERAL BALANCE SHEET ACCOUNTS

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* * * * *

3. *Discount, expense, and premium on funded debt.*—Ledger accounts shall be provided to cover the discounts, expense, and premiums at the sale or resale of each subclass of funded debt and of receiver's certificates issued for the benefit of or assumed by the company. For explanation of *subclass* see account No. 755, "Funded debt unmatured."

By the term *discount* is meant the excess of the par value of funded debt securities (of whatever kind) issued or assumed, and the accrued interest thereon, over the actual cash value of the consideration received for such securities.

By the term *premium* is meant the excess of the actual cash value of the consideration received for funded debt securities (of whatever kind) issued or assumed over the par value of such securities and the accrued interest thereon.

By the term *expense* is meant all expense in connection with the issue and sale of evidences of debt, such as fees for drafting mortgages and trust deeds; fees and taxes for issuing or recording mortgages and trust deeds; cost of engraving and printing bonds, certificates of indebtedness, and other negotiable paper having a life of more than one year; fees paid trustees provided for in mortgages and trust deeds; fees paid for legal services to trustees relative to mortgage securities; fees and commissions paid underwriters and brokers for marketing such evidences of debt; and other like expense.

The total of the net debit balances remaining in these several accounts should be included in account No. 725, "Discount on

funded debt," and the total of the net credit balances in account No. 772, "Premium on funded debt."

Each fiscal period there shall be charged to income account No. 548, "Amortization of discount on funded debt," a proportion (based upon the ratio of such fiscal period to the remaining life of the respective securities reckoned from the beginning of the period to the date of maturity of the debt to which the charges relate) of each of the debit balances in these accounts, and correspondingly there shall be credited to income account No. 517, "Release of premiums on funded debt," a similar proportion of each of the credit balances in these accounts. Carriers are allowed the option of extinguishing at any time, through charges to Profit and Loss, all or any portion of the debit balances remaining in any of these accounts and of deferring the extinguishment of credit balances until the maturity of the obligations represented.

When any funded debt which has been actually issued to bona fide holders for value is reacquired by the accounting company, that proportion of the balance remaining in the accounts containing discount, expense, and premium on funded debt for the subclass of the security reacquired applicable to the portion reacquired shall be credited or charged thereto, as may be appropriate, and concurrently charged or credited to Profit and Loss. Such proportion shall be based upon the ratio of the par value of the security reacquired to the par value of all the securities of the subclass actually outstanding immediately before such reacquirement.

In case, however, the premium realized or discount suffered at the prior sale of the se-

curities reacquired has been included (in excess of the amount authorized in the text of road and equipment account No. 76, "Interest during construction") in an asset account other than the premiums and discounts account, such asset account shall be concurrently adjusted through Profit and Loss to the extent of such excess of the premium or discount previously included therein with respect to the securities reacquired.

STATEMENTS FROM ACCOUNTING TEXTS

In Arthur Lowes Dickinson's "Accounting Practice and Procedure," the following statements are made (pp. 66, 134):

> Discounts and premiums on bonds are in effect an addition to or deduction from the interest rate paid on the bonds over their life, and as such should strictly be included with interest charges in the net income account by proper instalments each year.
>
> * * * * *
>
> Premium or discount on bonds is a deduction from or addition to the nominal rate of interest which the bond carries; that is to say, there is a rate known as the true or effective rate at which any corporation can place its bonds at par; *if it elects to place them at any other rate the bonds will sell at a premium or discount as the case may be; but the effective rate remains the same and this effective rate is the proper charge to Income account.* Hence the premium or discount should theoretically be spread over the term of the bonds, and the annual instalment thereof credited or charged to Income account each year. (Italics ours.)

Professor Earl A. Saliers, in "Accounts in Theory and Practice," states at pages 171–172:

> *Effective Interest Rate—Bonds Sold at Premium.*—When bonds are sold at a premium the same principles apply as when they are sold at a discount, but the effective rate of interest is less than the nominal rate. Suppose that the issue of bonds had sold at 110 instead of 90. The entry recording the sale follows:

Cash	$11,000	
To Bonds		$10,000
Premium on Bonds		1,000

Full explanation here.

The nominal rate of interest, that is, the rate paid on the par value of the bonds, is 5%. But the actual interest cost per annum is ($500–1/20 of $1,000)÷$11,000, or 4.09% reckoned on $11,000, or $450 per year. This rate of interest considers two factors which the nominal rate, 5%, ignores. The first factor is the $11,000 actually received for the bonds; the second factor is the premium on the bonds, of which 1/20 should be written off each year to reduce the amount of interest charged to Profit and Loss. The entries required are similar to those given above, with such alterations as may be seen by an examination of the following:

Profit and Loss	$37.50	
Premium on Bonds	4.16	
To Interest Accrued		41.66

To charge the Profit and Loss and Premium on Bonds accounts with the month's portion of interest accrued, and to credit the Interest Accrued account with the nominal rate of interest.

If interest is paid semiannually, at the end of each six months' period, Interest Accrued is charged and Cash is credited with $250, as shown above. Any slight discrep-

ancy existing in the Interest Accrued account can be carried to Profit and Loss, as already explained.

Premium or Discount Affects Profit and Loss.—From the foregoing discussion we see that if either a bond premium or a bond discount account is raised on the books when bonds are sold at other than par value, this premium or discount account must be considered as a factor aiding in the determination of the actual interest charge to be made to Profit and Loss. If the bonds sell at a discount, the amount of the discount should be prorated over the time the bonds run, the amount applicable to each period being added to the actual interest paid, i. e., the nominal interest, to determine the amount to be charged to Profit and Loss. If the bonds sell at a premium, the amount of the premiums should be prorated over the life of the bonds, and the amount applicable to each period should be subtracted from the actual interest paid to determine the amount to be charged as interest to Profit and Loss. * * *

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